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11  
12 UNITED STATES DISTRICT COURT  
13 CENTRAL DISTRICT OF CALIFORNIA  
14

15 Robert G. Perrin and Diane L. Perrin  
Individually and on Behalf of All  
16 Others Similarly Situated,

17 Plaintiffs,

18 v.

19 SouthWest Water Co., *et. al.*,

20 Defendants.  
21  
22  
23  
24  
25  
26  
27  
28

Case No. 2:08-CV-07844-JHN-AGR<sub>x</sub>

**OPPOSITION OF LEAD  
PLAINTIFFS TO DEFENDANT  
SOUTHWEST WATER  
COMPANY'S, ANTON C.  
GARNIER'S, MARK A. SWATEK'S,  
CHERYL L. CLARY'S, AND  
PETER J. MOERBEEK'S MOTION  
TO DISMISS CONSOLIDATED  
AMENDED CLASS ACTION  
COMPLAINT**

Date: May 10, 2010 (*Scheduled*)  
May 17, 2010 (*Proposed*)  
Time: 2:00 p.m.  
Judge: Hon. Jacqueline H. Nguyen  
Courtroom: 1600

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## 1 I. INTRODUCTION

2 For over three and one-half years, spanning fourteen consecutive financial  
 3 quarters from January 2005 through June 2008, Defendant SouthWest Water  
 4 Company (“SouthWest” or the “Company”) and certain of its officers and directors  
 5 repeatedly represented to the investing public that the Company’s financial  
 6 statements were presented in accordance with Generally Accepted Accounting  
 7 Principles (“GAAP”) and were free of any material error. Certain of these  
 8 defendants also certified over and over again that SouthWest’s internal accounting  
 9 controls – the very controls and procedures designed to ensure that its financial  
 10 statements were accurately reported – had no undisclosed material weaknesses. In  
 11 fact, each of these statements was utterly and indisputably false at the time it was  
 12 made and Defendants have now been forced to admit as much. On November 10,  
 13 2008, SouthWest finally advised the investing public that it should no longer rely  
 14 upon SouthWest’s previously issued financial statements. Upon learning of this  
 15 news, the financial markets reacted immediately and severely. SouthWest’s  
 16 common stock lost 36% of its value in just one day, falling \$2.97 to close at \$5.25  
 17 on extremely heavy volume. Ultimately, SouthWest admitted that, among other  
 18 things, it had materially misrepresented the Company’s financial condition by  
 19 improperly capitalizing costs that should have been expensed; failed to eliminate  
 20 intercompany profits; improperly recognized revenue; and failed to record  
 21 liabilities. These failures were no surprise to Defendants as they also admitted that  
 22 SouthWest “did not maintain an environment that consistently emphasized strict  
 23 compliance” with GAAP which “in certain instances led to inappropriate  
 24 accounting decisions and entries.”

25 The impact on investors of Defendants’ disclosures of SouthWest’s actual  
 26 financial condition was dramatic. Those who purchased SouthWest stock learned  
 27 that contrary to SouthWest’s prior statements, in fact, the Company’s “income” for  
 28 2004 was virtually non-existent; that retained earnings as of December 31, 2005



1 was actually only \$5 million rather than the \$22 million Defendants had reported;  
2 that the figure for 2006 retained earnings was overstated by over 328%, \$27 million  
3 instead of \$6.3 million; and that retained earnings for 2007 had been overstated by  
4 over 504%, \$13.3 million rather than \$2.2 million. Indeed, with the exception of  
5 2007, Defendants' accounting errors falsely portrayed SouthWest as a profitable  
6 company when it was not.

7 The damage caused to investors simply was not and cannot plausibly be  
8 explained as the result of mere innocent error. The sheer magnitude of the  
9 misstatements, the repeated nature of the accounting errors spanning over years and  
10 the simplicity of the accounting principles involved – including clear and long-  
11 standing principles of cost accounting and revenue recognition – undercut any  
12 inference of innocence. Likewise, the fact that *virtually every one of the*  
13 *accounting errors cut in favor of SouthWest* by inflating its financial results is  
14 further powerful evidence that the false statements were made either knowingly or  
15 recklessly. Finally, any inference of innocence is put to rest by Defendants' own  
16 admissions that its internal accounting controls were inadequate. Defendants  
17 ultimately admitted that the Company had material weaknesses in *fifteen distinct*  
18 *areas*, demonstrating that SouthWest's financial reporting environment lacked any  
19 semblance of controls to ensure the investing public that Defendants had any basis  
20 in fact to represent that its financial statements were fairly presented in accordance  
21 with GAAP.

22 In the face of Plaintiffs' detailed allegations, Defendants nonetheless seek  
23 dismissal principally on two grounds. First, they claim that the Complaint  
24 somehow does not fairly identify which statements are alleged to be false. Second,  
25 they assert that the Complaint fails to allege that Defendants acted with the mental  
26 state of scienter. Neither argument has merit.

27 As demonstrated below, the Complaint identifies each of the false statements  
28 Plaintiffs allege to be actionable. Defendants' contention that they are somehow in



1 the dark on this point is not only belied by the Complaint which assiduously details  
 2 each false statement and the reasons supporting why it was false at the time made,  
 3 but also by the very fact that they have already publicly admitted and identified  
 4 each of their false statements. It simply is not credible for them to now contend that  
 5 they do not know what this case is about.

6 The Complaint further sets forth powerful allegations that this massive,  
 7 protracted and self-serving accounting fraud – perpetrated in an environment  
 8 functionally devoid of any meaningful financial controls – was not the product of  
 9 simple incompetence by Defendants – two of whom were themselves experienced  
 10 accountants. The multiple facts evidencing Defendants’ knowing or reckless  
 11 conduct – when considered collectively – easily satisfy the pleading standards set  
 12 forth by the Supreme Court and the Ninth Circuit. Accordingly, the motion to  
 13 dismiss should be denied in its entirety.

## 14 **II. FACTUAL BACKGROUND**

15 This is a securities class action on behalf of all persons or entities who  
 16 acquired SouthWest stock between May 10, 2005 and November 10, 2008 (the  
 17 “Class Period”) against SouthWest and certain of its officers and directors and  
 18 affiliates. ¶ 1.<sup>1</sup> SouthWest provides water, wastewater treatment, and public works  
 19 in nine states. ¶ 28. Defendant Anton Garnier was the CEO and Chairman of  
 20 SouthWest’s Board of Directors until his resignation on May 15, 2006. ¶ 29.  
 21 Defendant Mark Swatek became the CEO when Garnier resigned and remains in  
 22 that position today. ¶ 30. Defendant Cheryl Clary, a certified public accountant,  
 23 was the Company’s Senior Vice President of Finance and Chief Financial Officer  
 24 during the Class Period. ¶ 31. Defendant Moerbeek was SouthWest’s President  
 25 and Chief Operating Officer and has been a certified public accountant for over  
 26 thirty years. ¶ 32.<sup>2</sup>

27 <sup>1</sup> All citations herein in the format “¶ \_\_” are to Plaintiffs’ Consolidated Amended  
 28 Class Action Complaint.

<sup>2</sup> Together, Garnier, Swatek, Clary, and Moerbeek are the “Individual Defendants.”

Defendants continuously presented a highly favorable picture of the Company's financial condition, results of operations, and internal controls. ¶¶ 240-404. For example, Defendants claimed that SouthWest had experienced incremental quarterly increases in operating income during each of the first three quarters of each of the respective fiscal years during the Class Period and had achieved sequential growth in annual reserves during that time.<sup>3</sup> Also, in each quarter during the Class Period, Defendants stated that SouthWest's internal controls suffered from no material weaknesses or that all material weaknesses had been disclosed.<sup>4</sup> Defendants also repeatedly claimed that the Company's financial statements had been prepared in accordance with GAAP.<sup>5</sup>

As Defendants were eventually forced to admit, their financial statements were false at the time they were made and the claimed financial performance was dramatically overstated. On November 10, 2008, the Company announced that its financial statements for 2005, 2006, and 2007, and the first two quarters of 2008 could no longer be relied upon and would be restated. ¶¶ 4, 405-06. The Company acknowledged that it had committed widespread accounting errors and made "inappropriate accounting decisions" over the previous years, which had inflated the Company's financial results. ¶¶ 3, 171, 406. Specifically, Defendants capitalized costs that should have been expensed, failed to eliminate intercompany profits, under-appreciated assets, recognized revenue on the cash basis instead of the accrual basis, failed to account for existing liabilities, and improperly accounted for acquisitions, among other violations of GAAP. ¶¶ 2, 127-61, 239. The Company also revealed that its financial internal controls "system" had suffered from *fifteen* material weaknesses during the Class Period, each of which went to the very core of its financial reporting, including that it "did not maintain an

<sup>3</sup> ¶¶ 17, 240, 242, 252, 254, 262, 264, 275, 277, 284, 293, 295, 302, 306, 315, 318, 329, 331, 340, 342, 349, 351, 357, 360, 367, 369, 382, 385, 393, 396.

<sup>4</sup> ¶¶ 244-45, 256-57, 266-67, 281-87, 297-99, 308-10, 320-22, 334-36, 344-46, 353-55, 362-64, 375-78, 387-90, 398-400.

<sup>5</sup> ¶¶ 241, 253, 263, 276, 294, 305, 317, 330, 341, 350, 359, 371, 384, 395.

environment that consistently emphasized strict adherence to generally accepted accounting principles.” ¶¶ 3, 171.<sup>6</sup> This revelation was striking given that Clary, Garnier, and Swatek repeatedly signed certifications required by the Sarbanes-Oxley Act (“SOX”) representing they had designed internal controls, had recently evaluated those controls, and that the controls were effective. ¶¶ 104-07, 166.

The effects of the Company’s financial restatement (“Restatement”) were staggering. Revenue was adjusted downward for each of the years 2004, 2005, 2006, and 2007. ¶ 55. Operating income, net income, and income from continuing operations were all drastically cut for the years 2004, 2005, and 2006.<sup>7</sup> *Id.* For example, the Restatement turned nearly \$2.4 million of 2005 net income into a \$397,000 *loss* for that year. *Id.* Income from continuing operations was also adjusted downward for the first and second quarters of 2008. ¶¶ 60-61. Retained earnings for 2005, 2006, and 2007 were each drastically cut: from \$22.2 million to \$5 million for 2005, from \$27 million to \$6.3 million for 2006, and from \$13.3 million to \$2.2 million for 2007. ¶¶ 62-64. Finally, net cash for 2006 and 2007 were reduced to only 21% and 26% of their previously reported levels, respectively. ¶¶ 65-66.

### III. ARGUMENT

#### A. Legal Standard

The Supreme Court’s decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), reaffirms that, even in securities fraud cases, courts must accept the factual allegations in a plaintiff’s complaint as true and draw all reasonable inferences in the plaintiff’s favor on a motion to dismiss. *See id.* at 322.

To establish a claim under Section 10(b) and Rule 10-b(5), a plaintiff must

<sup>6</sup> Significantly, the absence of internal controls existed throughout the Class Period. ¶ 171 (noting that the internal control deficiencies resulted in the adjustments to financial statements dating throughout the Class Period).

<sup>7</sup> These figures were adjusted upward for 2007, but only because of the reversal of an unusually large \$17.3 million goodwill impairment charge taken in the fourth quarter of that year. ¶ 55.

1 demonstrate (1) a misrepresentation or omission of material fact, (2) scienter, (3) a  
 2 connection with the purchase or sale of a security, (4) transaction and loss  
 3 causation, and (5) economic loss. *In re Daou Sys., Inc. Sec. Litig.*, 411 F.3d 1006,  
 4 1014 (9th Cir. 2005). Rule 9(b) and the Private Securities Litigation Reform Act  
 5 (“PSLRA”) require a complaint to “plead with particularity both falsity and  
 6 scienter[.]” *Id.* at 1014-15.

7 To plead scienter, the Complaint must create a strong inference that  
 8 Defendants acted knowingly or with deliberate recklessness. *See id.* at 1014-15.  
 9 “[C]ourts must consider the complaint in its entirety . . . . The inquiry . . . is  
 10 whether *all* of the facts alleged, taken collectively, give rise to a strong inference of  
 11 scienter, not whether any individual allegation, scrutinized in isolation, meets that  
 12 standard.” *Tellabs*, 551 U.S. at 322-23. A strong inference of scienter arises if,  
 13 “[w]hen the allegations are accepted as true and taken collectively,” a reasonable  
 14 person would “deem the inference of scienter at least as strong as any opposing  
 15 inference[.]” *Id.* at 324. The “inference that the defendant acted with scienter need  
 16 not be irrefutable, *i.e.*, of the ‘smoking-gun genre,’ or even the ‘most plausible of  
 17 competing inferences.’” *Id.* at 324.

18 “No scienter is required for liability under § 11; defendants will be liable for  
 19 innocent or negligent material misstatements or omissions.” *Daou*, 411 F.3d at  
 20 1027. “The plaintiff in a § 11 claim must demonstrate (1) that the registration  
 21 statement contained an omission or misrepresentation, and (2) that the omission or  
 22 misrepresentation was material, that is, it would have misled a reasonable investor  
 23 about the nature of his or her investment.” *Id.* Significantly, “the heightened  
 24 pleading requirements of the PSLRA do not apply to section 11 claims.” *Rubke v.*  
 25 *Capitol Bancorp, Ltd.*, 551 F.3d 1156, 1161 (9th Cir. 2009).<sup>8</sup> Instead, in ruling on a

26 <sup>8</sup> Defendants wrongly contend that the Section 11 claims “sound in fraud,” and that  
 27 Rule 9(b)’s particularity requirements are therefore applicable (Memo. of Points &  
 28 Auth. in Supp. of Mot. to Dismiss Consolidated Amended Class Action Complaint  
 (“SW Br.”), at 5-6), despite the fact that Plaintiffs have explicitly averred that these  
 claims are not premised on fraud and have instead plead ordinary negligence. ¶¶

1 motion to dismiss, a court should not require “heightened fact pleading of specifics,  
 2 but only enough facts to state a claim to relief that is plausible on its face.” *Bell Atl.*  
 3 *v. Twombly*, 550 U.S. 544, 570 (2007). *Twombly*’s requirement of “facial  
 4 plausibility” is satisfied “when the plaintiff pleads factual content that allows the  
 5 court to draw the reasonable inference that the defendant is liable for the  
 6 misconduct alleged.” *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009). Even after  
 7 *Twombly* and *Iqbal*, the Supreme Court did not impose a heightened pleading  
 8 standard for claims subject to Rule 8 (such as Section 11 claims). *See Twombly*,  
 9 550 U.S. at 569 n.14.

#### 10 **B. The Complaint Adequately Alleges Each False and/or Misleading** 11 **Statement**

12 To satisfy the PSLRA, a complaint alleging securities fraud must “specify  
 13 each statement alleged to have been misleading, the reason or reasons why the  
 14 statement is misleading, and, if an allegation regarding the statement or omission is  
 15 made on information and belief, the complaint shall state with particularity all facts  
 16 on which that belief is formed.” *See Daou*, 411 F.3d at 1014. In this case, the  
 17 Restatement serves as an admission that the Company’s financial information and  
 18 its statements about its internal controls and GAAP compliance were materially

19  
 20 197, 208; *see In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 270-72 (3d  
 21 Cir. 2006) (“[W]here, as here, individual defendants are accused in separate claims  
 22 of the same complaint of having violated Section 11 . . . and Section 10(b), the  
 23 Securities Act claims do not sound in fraud if ordinary negligence is expressly pled  
 24 in connection with those claims.”); *In re Exodus Commc’ns, Inc. Sec. Litig.*, No. C-  
 25 01-2661, 2005 U.S. Dist. LEXIS 34449, at \*3-5 (N.D. Cal. Sept. 12, 2005). In  
 26 addition, by pleading the Section 11 allegations before and wholly apart from the  
 27 Section 10(b) allegations, Plaintiffs have “carefully segregated” those allegations.  
 28 *See Suprema*, 438 F.3d at 273 (“Plaintiff carefully segregated its allegations of  
 negligence . . . from its allegations of fraud . . . by pleading its Section 11 . . .  
 claims in negligence before – and wholly apart from – pleading its fraud-based  
 Section 10(b) claims. This manner of pleading makes for a clear conceptual  
 separation in the complaint between claims sounding in negligence and those  
 sounding in fraud.”); *Tsirekidze v. Syntax-Brilliant Corp.*, No. 07-02204, 2009 U.S.  
 Dist. LEXIS 8464, at \*21-22 (D. Ariz. Jan. 30, 2009) (applying *Suprema* even  
 where plaintiffs relied on same facts to support Section 10(b) and Section 11  
 claims); *see also In re Exodus*, 2005 U.S. Dist. LEXIS 34449, at \*4-5.

1 false.<sup>9</sup>

2 The Complaint easily meets the PSLRA pleading standard. For each of the  
3 fourteen quarters covered by the Class Period, the Complaint identifies the false and  
4 misleading statements made therein and explains why each statement is false and/or  
5 misleading. For example, with respect to the allegations regarding statements made  
6 during the first quarter of 2005, the Complaint alleges statements made by  
7 Defendants describing SouthWest's financial results and claiming that the  
8 Company's financial statements had been prepared in accordance with GAAP. ¶¶  
9 240-42. The Complaint then explains that those statements were false and  
10 misleading because "the Company's financial results materially misstated revenues,  
11 operating income, net income, earnings per share, and stockholders' equity, in  
12 violation of GAAP, which in turn materially misstated the company's statements of  
13 financial condition and cash flows." ¶ 243. The Complaint next quotes statements  
14 by Defendants Garnier and Clary claiming that all material weaknesses in internal  
15 controls had been identified. ¶ 244. The Complaint explains that such statements  
16 were false because they "failed to disclose that there were several other material  
17 weaknesses in internal controls, as enumerated [elsewhere in the Complaint]." ¶  
18 245. The Complaint's additional allegations of false and misleading statements are  
19 structured in the same manner as this example. ¶¶ 244-403; *see* Appendix A  
20 (Structure of Complaint's Allegations of False and Misleading Statements Under  
21 the Exchange Act).<sup>10</sup>

22 <sup>9</sup> *See* 17 C.F.R. § 210.4-01(a)(1) ("Financial statements filed with the Commission  
23 which are not prepared in accordance with generally accepted accounting principles  
24 will be presumed to be misleading or inaccurate[.]"); *Kaltman v. Key Energy Servs.*,  
25 447 F. Supp. 2d 648, 658 (W.D. Tex. 2006) ("[The company's] announcement of  
26 the need to restate its earnings constitutes an admission that its public filings are  
27 false."); *see also Varghese v. China Shenghuo Pharm. Holdings, Inc.*, No. 08 Civ.  
28 7422, 2009 U.S. Dist. LEXIS 114819, at \*17 (S.D.N.Y. Dec. 9, 2009) ("Misreported financial information clearly amounts to a false statement of fact.").

<sup>10</sup> It is not clear whether Defendants are challenging the false statements pled under  
Section 11. ¶¶ 93-108. Notably, Defendants do not point to any Section 11  
allegations that they consider to be deficient. *See* SW Br. at 8 (citing only to ¶¶  
240-403, which concern the Section 10(b) claims). In any event, the Section 11  
allegations are sufficient under both the Rule 8 and Rule 9(b) pleading standards.



Defendants raise a series of boilerplate objections to Plaintiffs' falsity allegations but fail to explain how those objections are applicable here. Defendants accuse Plaintiffs of "puzzle style pleading," yet tellingly, Defendants do not identify *any* specific allegations that are in any way problematic. *See* SW Br. at 8 (merely citing to ¶¶ 240-403 generally). Therefore, Plaintiffs and the Court can only guess about which allegations Defendants believe to be deficient. In any event, as the example above shows, the Complaint's allegations are fully compliant with the PSLRA. Moreover, as Defendants have admitted that SouthWest's financial statements were materially false and identified the specific portions of the financial statements that were false, it is not credible for them to now argue they are unable to discern which statements are alleged to be actionable.

Defendants are also wrong in claiming that the Complaint does not adequately explain why the various statements were false, SW Br. at 8, as the example above plainly demonstrates. Indeed, for every group of false statements alleged, the Complaint explains in great detail the reasons why the statements are false.<sup>11</sup> No more is required by the PSLRA. *See* 15 U.S.C. § 78u-4(b)(1).

Defendants also argue that the Restatement does not establish the falsity of financial information that was left unchanged by the Restatement nor of "soft" (*i.e.*, non-financial) information. SW Br. at 9. This argument is a non-starter. First, Plaintiffs do not contend that any portion of the financial statements that was not restated was false or misleading. Further, Defendants do not explain which statements in the Complaint they consider "soft information" nor do they identify even a single statement that the Complaint alleges to be false which the

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The Complaint alleges with particularity numerous untrue statements of material fact that appeared in SouthWest's registration statements and explains why each was untrue and material, ¶¶ 93-108, which is more than adequate to satisfy Rule 9(b) as well as the lesser Rule 8 standard. *See Daou*, 411 F.3d at 1028.

<sup>11</sup> Each of these paragraphs informs Defendants of the specific reasons why each statement was false. *See, e.g.*, ¶¶ 243, 245, 255, 257, 265, 268, 278-80, 283, 285, 287, 296, 299, 307, 310, 319, 322, 332-33, 336, 343, 346, 352, 355, 361, 364, 372-74, 378, 386, 390, 397, 400.



1 Restatement did not actually establish as false. If by “soft information,” they are  
 2 referring to the statements claiming the financials were prepared in accordance with  
 3 GAAP or the statements purporting to identify all material weaknesses in internal  
 4 controls, those were certainly rendered false by the Restatement. The Restatement  
 5 was premised on the occurrence of gross GAAP violations and the Restatement  
 6 conceded that such violations had occurred, ¶¶ 116-61, 171, 174-78, rendering false  
 7 Defendants’ statements<sup>12</sup> that the financials were compliant with GAAP. Also, the  
 8 Restatement identified *fifteen* material weaknesses that had not been previously  
 9 disclosed, ¶¶ 67-68, 171, which rendered false Defendants’ earlier statements<sup>13</sup> that  
 10 all material weaknesses had been disclosed or that the controls were effective.<sup>14</sup>

### 11 **C. The Complaint Adequately Alleges Scienter<sup>15</sup>**

12 The inquiry as to whether “*all* of the facts alleged, collectively, give rise to a  
 13 strong inference of scienter . . . is inherently comparative.” *Tellabs*, 551 U.S. at  
 14 322-23. “[A] court must consider plausible, nonculpable explanations for the  
 15 defendant’s conduct, as well as inferences favoring the plaintiff” and “[t]he  
 16 inference that the defendant acted with scienter need not be . . . the most plausible  
 17 of competing inferences[.]” *Id.* at 324.

18 As discussed below, the evidence supporting scienter is overwhelming: the  
 19 enormity of the accounting errors and GAAP violations that persisted for years, the  
 20 simplicity of the accounting rules that were violated, the sheer number of  
 21 accounting errors, the near total lack of internal controls, the fact that almost all the  
 22 errors favored the Company, the numerous red flags including letters from the SEC

23 <sup>12</sup> ¶¶ 241, 253, 263, 276, 294, 305, 317, 330, 341, 350, 359, 371, 384, 395.

24 <sup>13</sup> ¶¶ 244-45, 256-57, 266-67, 281-87, 297-99, 308-10, 320-22, 334-36, 344-46, 353-  
 55, 362-64, 375-78, 387-90, 398-400.

25 <sup>14</sup> Defendants also take issue with the Complaint’s use of block quotes, arguing that  
 26 the Complaint does not indicate which statements within the block quotes are  
 alleged to be false. Defendants point to no specific block quote that they find  
 problematic, and even a quick look at the Complaint shows their argument is  
 meritless.

27 <sup>15</sup> Scienter is not an element of Plaintiffs’ Section 11 claims, regardless of whether  
 28 Rule 8 or Rule 9(b) governs that claim’s pleading standard. *See Daou*, 411 F.3d at  
 1027.

questioning the Company's accounting, Defendants' false certifications in which they admitted knowledge on these subjects, corroboration by a confidential witness, Defendants' positions and accounting sophistication and the importance of the transactions at issue, and Defendants' incentive compensation and insider trading. Taken together, these facts create a strong inference that each of the Defendants knew their statements were false when made, or were utterly reckless in not so knowing, which easily outweighs any conceivable non-culpable inference.

Defendants have not endeavored to weigh competing inferences, nor have they even presented a non-culpable inference. Instead, Defendants repeatedly claim that each of Plaintiffs' scienter allegations is insufficient, by itself, to raise a strong inference. In doing so, Defendants ignore *Tellabs*'s command to look at scienter allegations "holistically" – not to "scrutinize each allegation in isolation[.]" *Id.* at 326; accord *S. Ferry LP, #2 v. Killinger*, 542 F.3d 776, 784-85 (9th Cir. 2008) ("*Tellabs* counsels us to consider the totality of circumstances, rather than to develop separately rules of thumb for each type of scienter allegation."). Each of the scienter allegations discussed below provides support for a strong inference of scienter and, when considered together, are more than sufficient to meet the PSLRA standard, as courts have repeatedly held in cases involving similar facts as here.<sup>16</sup>

### 1. GAAP Violations and the Magnitude of the Restatement Support a Strong Inference of Scienter

<sup>16</sup> See, e.g., *Stocke v. Shuffle Master, Inc.*, 615 F. Supp. 2d 1180, 1188-93 (D. Nev. 2009) (strong inference of scienter as to false financial statements was established where Plaintiffs pled GAAP violations, false SOX certifications, and weak internal controls); *Backe v. Novatel Wireless, Inc.*, 642 F. Supp. 2d 1169, 1187 (S.D. Cal. 2009) (scienter established based on defendants' positions within company, small size of company, violation of basic GAAP, lack of internal controls, stock sales, and corroboration by confidential witness); *In re UTStarcom, Inc. Sec. Litig.*, 617 F. Supp. 2d 964, 973-77 (N.D. Cal. 2009) (scienter established by overstated revenue, GAAP violations, awareness of internal control problems, resignations, and stock sales); *In re Impax Lab., Inc. Sec. Litig.*, No. 04-04802, 2007 U.S. Dist. LEXIS 52356, at \*20-32 (N.D. Cal. July 18, 2007) (scienter established by GAAP violations, resignations, importance of business area to company); *In re Lattice Semiconductor Corp. Sec. Litig.*, No. 04-1255, 2006 U.S. Dist. LEXIS 262, at \*33-56 (D. Or. Jan. 3, 2006) (scienter established by GAAP violations, Defendants' access to information about financial data, SOX certifications).

1 The numerous and blatant GAAP violations alleged in the Complaint provide  
 2 support for a strong showing that Defendants acted knowingly or recklessly with  
 3 respect to the accounting fraud. Although GAAP violations are insufficient to  
 4 establish scienter *on their own*, the Ninth Circuit has squarely held that  
 5 “[v]iolations of GAAP standards can [] provide evidence of scienter.” *Daou*, 411  
 6 F.3d at 1016; *accord In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248,  
 7 1273 (N.D. Cal. 2000) (“When significant GAAP violations are described with  
 8 particularity in the complaint, they may provide powerful indirect evidence of  
 9 scienter. After all, books do not cook themselves.”); *In re Cylink Sec. Litig.*, 178 F.  
 10 Supp. 2d 1077, 1082 (N.D. Cal. 2001); *Stocke*, 615 F. Supp. 2d at 1189-90.<sup>17</sup> In the  
 11 Complaint, Plaintiffs set forth the Company’s improper accounting practices, the  
 12 GAAP provisions that were violated, the amount of the improper accounting and  
 13 fiscal periods affected, and the impact of the improper accounting on each affected  
 14 financial statement. ¶¶ 51-66, 116-78.

15 The GAAP violations alleged in the Complaint are especially probative of  
 16 scienter because they were of basic accounting principles, they were pervasive in  
 17 that they affected several different areas of the Company’s business, they were  
 18 numerous, and they occurred repeatedly over a long period of time. Notably,  
 19 Defendants do not argue that the applicable accounting rules were complex or that  
 20 the violations were not obvious, nor could they. Defendants violated several basic  
 21 and longstanding GAAP rules<sup>18</sup> pertaining to the timing of the depreciation of  
 22 expenses, the need to record revenue<sup>19</sup> under the accrual basis rather than the cash

23 <sup>17</sup> Defendants have not cited any authority to contradict this principle. *In re U.S.*  
 24 *Aggregates, Inc. Sec. Litig.*, 235 F. Supp. 2d 1063, 1073 (N.D. Cal. 2002) simply  
 25 held that a GAAP violation is not necessarily sufficient to establish scienter on its  
 own. Also, in *U.S. Aggregates* and unlike here, the GAAP violations alleged in the  
 Complaint were not solely responsible for the magnitude of the restatement. *Id.*

26 <sup>18</sup> Most of these rules have been in place for decades. *See* Declaration of Michael  
 27 Goldberg, Ex. A at 1-1 (FASCON 1, issued 1978); Ex. B at 5-1 (FASCON 5, issued  
 1984); Ex. C at 6-1 (FASCON 6, issued 1985); Ex. C at 5-1 (SFAS 5, issued 1975);  
 28 Ex. D at 57-1 (SFAS 57, issued 1982); Ex. E at 71-1 (SFAS 71, issued 1982); Ex. F  
 at 141-1 (SFAS 141, issued 2001).

<sup>19</sup> “[C]ourts have recognized that accounting manipulations involving premature

1 basis, capitalization of assets, and accounting for intercompany transactions, among  
 2 other rules. *See, e.g.*, ¶¶ 11, 134, 36. Moreover, the accounting errors were  
 3 massive and dated from 2004 through the second quarter of 2008. ¶¶ 55-61. That  
 4 Defendants violated these several basic provisions of GAAP, and for so long,  
 5 supports an inference that their conduct was knowing or, at minimum, reckless. *See*  
 6 *In re MicroStrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 635-36 (E.D. Va. 2000)  
 7 (scienter properly pled where complaint detailed “the magnitude of the restated  
 8 financials and the pervasiveness and repetitiveness of . . . GAAP violations; the  
 9 simplicity of the accounting principles violated . . . and the importance of the  
 10 contracts involved”).

11 Particularly revealing is the fact that almost all of the accounting errors  
 12 *avored* the Company and served to inflate its financial results. ¶¶ 127-61  
 13 (describing seven types of errors, only one of which – goodwill accounting –  
 14 underreported results). If the accounting errors were merely inadvertent, one would  
 15 expect roughly equivalent numbers of “harmful” and “helpful” errors. But here,  
 16 almost all of the errors led to *upward* adjustments to the Company’s financials. ¶¶  
 17 55, 59-61. A statistical anomaly such as this is the fingerprint of intentional  
 18 misconduct. In *Middlesex Retirement System v. Quest Software Inc.*, 527 F. Supp.  
 19 2d 1164, 1181-82 (C.D. Cal. 2007), the court held that the complaint adequately  
 20 pled that the defendants had intentionally back-dated stock options where those  
 21 options had suspiciously been granted on dates that “reflect either the lowest prices  
 22 for a period exceeding six months, or are prices that immediately preceded rapid  
 23 increases in the price of [the Company’s stock].” The court held that such  
 24 “extremely fortunate dates give rise to a strong inference that backdating has  
 25 occurred and that it was done intentionally.” *Id.* at 1182. As in *Middlesex*, here it

26  
 27 revenue recognition . . . are especially indicative of conscious misbehavior since  
 28 such violations do not commonly occur inadvertently, but instead suggest a  
 conscious decision to improperly recognize revenue.” *In re Veeco Instruments, Inc.*  
*Sec. Litig.*, 235 F.R.D. 220, 231-32 (S.D.N.Y. 2006).

1 is “highly improbable that a failure to comprehend the proper accounting treatment  
2 . . . would so consistently benefit Defendants.” *Id.* at 1183.

3 In addition, the sheer magnitude of the Restatement is also strong evidence  
4 that Defendants knew, or were reckless in not knowing, that the accounting was  
5 flawed. As an indication of magnitude, practically all of the 2004 income was  
6 wiped out by the Restatement, shareholder equity as of December 31, 2005 was  
7 reduced from \$22.2 million to \$5.0 million, 2006 retained earnings were reduced  
8 from \$27 million to \$6.3 million, and 2007 retained earnings were reduced from  
9 \$13.3 million to \$2.2 million. ¶¶ 10, 55-66. In other words, Defendants had  
10 overstated the 2006 and 2007 retained earnings by over 328% and 504%,  
11 respectively. Defendants also falsely represented that SouthWest was profitable in  
12 2005, 2006, and for the first two quarters of 2008, when it was not. The enormity  
13 of the Restatement is highly probative of scienter. *See Institutional Investors*  
14 *Group v. Avaya, Inc.*, 564 F.3d 242, 271 (3d Cir. 2009) (“the magnitude of the  
15 alleged [accounting errors] strengthens the inference of scienter”).<sup>20</sup>

## 16 **2. The Lack of Internal Controls Supports a Strong Inference** 17 **of Scienter**

18 During the Class Period, the Company suffered from a near total lack of  
19 internal controls over its financial reporting. In conjunction with the Restatement,  
20 the Company belatedly identified *fifteen* material weaknesses that each went to the  
21 very core of its financial reporting, including that it “did not maintain”:

- 22 • “an effective control environment”;
- 23 • “an environment that consistently emphasized strict adherence to generally

24 <sup>20</sup> *See also Atlas v. Accredited Home Lenders Holding Co.*, 556 F. Supp. 2d 1142,  
25 1156 (S.D. Cal. 2008) (“[T]he sizable impact on [the company’s] reported earnings  
26 of these alleged violations of GAAP also supports an inference of scienter.”);  
27 *Batwin v. Occam Networks, Inc.*, No. 07-2750, 2008 U.S. Dist. LEXIS 52365, at  
28 \*37-38 (C.D. Cal. July 1, 2008) (overstatement of revenues by over 30 and 40%  
“over an extended period of time” – two and a half years – gives “rise to a strong  
inference of scienter”); *In re Catalina Marketing Corp. Sec. Litig.*, 390 F. Supp. 2d  
1110 (M.D. Fla. 2005) (overstatement of income by 43% supports inference of  
scienter); *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 506-07 (W.D. Pa. 2002).



- 1 accepted accounting principles”;
- 2 • “complete and accurate business documentation to support certain
  - 3 transactions and accounting records”;
  - 4 • “effective monitoring of controls over [several] areas”;
  - 5 • “sufficient and consistent accounting policies with respect to generally
  - 6 accepted accounting principles”;
  - 7 • “effective controls over the application of generally accepted accounting
  - 8 principles commensurate with financial reporting requirements”;
  - 9 • “effective controls over the completeness and accuracy of our accounting for
  - 10 acquisitions”;
  - 11 • “effective controls over the completeness, accuracy and valuation of our
  - 12 accounting estimates related to [various] claims process[es]”;
  - 13 • “effective controls over the completeness and accuracy of our accounting for
  - 14 the impairment of goodwill”;
  - 15 • “effective controls over the completeness and accuracy of our accounting for
  - 16 regulated entities”;
  - 17 • “effective controls over the completeness and accuracy of property, plant and
  - 18 equipment and related depreciation expense”;
  - 19 • “effective controls over the completeness and accuracy of unbilled utilities
  - 20 revenue”;
  - 21 • “effective controls to ensure the completeness of the recording of [various
  - 22 expenses] on a timely basis,” among others. ¶ 171.

23 In short, SouthWest effectively had no internal controls.

24 “[A] failure to maintain sufficient internal controls to avoid fraud is

25 sufficiently indicative of scienter.” *Veeco*, 235 F.R.D. at 232; *accord China*

26 *Shenghuo*, 2009 U.S. Dist. LEXIS 114819, at \*21. Here. Defendants knew or

27 recklessly disregarded that their accounting was flawed and could not be trusted.

28 At minimum, Defendants were willfully blind to the numerous accounting

violations. *See In re PainCare Holdings. Sec. Litig.*, 541 F. Supp. 2d 1283, 1293

(M.D. Fl. 2007) (holding that lack of internal controls showed, at least, that

“Defendants took great care *not* to ‘know’ [of fraud]” and rejecting idea that “a

Company can ignore the elephant in the room, as long as no one *told* them it was

there”), *adopted by district court*, 541 F. Supp. 2d 1283, 1286 (2008); *In re Atlas*

1 *Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 492 n.9 (S.D.N.Y.  
 2 2004) (“[T]he allegations concerning deficient internal controls bolster[] the other  
 3 factual allegations in the Complaint that tend to show that the individual defendants  
 4 recklessly issued the company’s financial statements.”).<sup>21</sup>

5 The lack of internal controls is especially probative here, where Defendants  
 6 understood that internal control deficiencies existed yet failed to correct them. ¶¶  
 7 420-21, 430-31; *see Batwin*, 2008 U.S. Dist. LEXIS 52365, at \*40-41 (failure to  
 8 correct internal control deficiencies that had been brought to the attention of the  
 9 defendants gave rise to a strong inference of scienter). Also, the degree to which  
 10 Defendants’ statements about internal controls were false is evidence that  
 11 Defendants knew those statements were false; it is one thing to claim that internal  
 12 controls are effective when one or two problems exist, but it is quite another to do  
 13 so when there are *fifteen* pervasive material weaknesses.

### 14 **3. Numerous Additional Red Flags Support a Strong Inference** 15 **of Scienter**

16 In addition to the sheer magnitude of the accounting errors and internal  
 17 control deficiencies, there were several other red flags that support a strong  
 18 inference of scienter. *See Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901,  
 19 918 (6th Cir. 2007) (“Specific factual allegations that a defendant ignored red flags,  
 20 or warning signs that would have revealed the accounting errors prior to their  
 21 inclusion in public statements, may support a strong inference of scienter.”).<sup>22</sup>

22 <sup>21</sup> The cases cited by Defendants on this point, at best, hold that a lack of internal  
 23 controls, without additional facts, is not necessarily sufficient on its own to show  
 24 scienter. *See In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1158  
 25 (C.D. Cal. 2007) (“[W]ithout additional facts, a lack of internal controls generally  
 26 does not suffice to show scienter.”); *Comm. Workers of Am. Plan for Employees’*  
 27 *Pensions & Death Benefits v. CSK Auto Corp.*, No. 06-1503, 2007 U.S. Dist.  
 28 LEXIS 22782, at \*27 (D. Ariz. Mar. 28, 2007) (“Without [supporting] facts, a lack  
 of internal controls generally does not suffice to show scienter.”). These cases do  
 not suggest that detailed allegations of deficient internal controls are not sufficient,  
 especially when combined with other scienter allegations, as here.

<sup>22</sup> *See also In re Friedman’s, Inc. Sec. Litig.*, 385 F. Supp. 2d 1345, 1361 (N.D. Ga.  
 2005); *Norfolk County Ret. Sys. v. Ustian*, No. 07-7014, 2009 U.S. Dist. LEXIS  
 65731, at \*24-35 (N.D. Ill. July 28, 2009) (red flags contributed to strong inference



1 During the Class Period, the Company reported different financial data to  
 2 various state regulatory agencies than it did in its SEC filings. ¶ 422. In one  
 3 instance, the Company was asked to explain the discrepancy in its reports of  
 4 depreciation accounting. ¶ 423. Although the Company claimed that different  
 5 accounting rules were applicable to the two filings, it also admitted that there were  
 6 “no depreciation studies . . . justifying the depreciation rates used by the  
 7 Company.” ¶ 424. Significantly, the Restatement was based in part on errors in  
 8 depreciation accounting and the Company identified internal control weaknesses in  
 9 that specific area. ¶¶ 127-36, 171(13).<sup>23</sup>

10 Defendants Clary and SouthWest also received warnings from the SEC that  
 11 went directly to reporting and accounting issues surrounding the Restatement. ¶¶  
 12 428-29. In particular, in an October 12, 2006 letter, the SEC questioned  
 13 SouthWest’s report of a \$15.7 million increase in revenue and concluded that “the  
 14 disclosure of your revenue recognition between affiliates is unclear.” ¶ 428.  
 15 Despite this warning, Defendants continued to improperly recognize revenue  
 16 between affiliates. ¶¶ 142-47.<sup>24</sup>

17 of scienter); *In re Am. Serv. Group, Inc.*, No. 06-0323, 2009 U.S. Dist. LEXIS  
 18 28237, at \*146-47 (M.D. Tenn. Mar. 30, 2009) (red flags established strong  
 19 inference of scienter); *In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1030  
 20 (N.D. Ohio 2000) (“[A]llegations of obvious ‘red flags,’ or warning signs that  
 21 financial reports are misstated, can, where the misstatements are of a substantial  
 22 magnitude, give rise to a strong inference of fraudulent intent.”)

23 <sup>23</sup> Defendants challenge these allegations based on the fact that the Company was  
 24 asked about the accounting discrepancy towards the end of the Class Period. SW  
 25 Br. at 17. However, the Company provided the different financial data to state  
 26 regulators in June 2007. ¶ 423. Therefore, well before the end of the Class Period,  
 27 the Company was presenting inconsistent financial information – information now  
 28 admitted to be false. Defendants also argue that the Complaint does not specifically  
 allege that Defendants knew about the discrepancy. SW Br. at 17. However,  
 knowledge about such a critical part of the Company’s business as an application  
 for a rate increase is presumed by high-level Company officials such as the  
 Individual Defendants. *See South Ferry LP v. Killinger*, 542 F.3d 776, 784 (9th  
 Cir. 2008).

<sup>24</sup> *Glover v. DeLuca*, No. 03-0288, 2006 U.S. Dist. LEXIS 76093 (W.D. Pa. Sept.  
 29, 2006), cited by Defendants, is factually dissimilar. There, the court held that  
 “based on the content of the letters between the SEC and [the defendants,]” the  
 court was unable to draw an inference of scienter because there was “no factual  
 support for Plaintiff’s speculation” that the SEC was concerned about improper  
 acquisition accounting. *Id.* at \*46-47. Here, the SEC specifically questioned the

1        These red flags did not go unnoticed by Defendant Swatek, in particular, as  
 2        he acknowledged many of the internal control problems during the Class Period.  
 3        For example, on March 16, 2007, Swatek acknowledged that the Company's  
 4        acquisition spree had led to accounting systems problems. Swatek stated that the  
 5        Company was using "11 different ledgers in five billing systems all with numerous  
 6        manual interfaces" which he noted was "clearly inefficient[.]" ¶ 420. He also  
 7        stated that the Company was "manually working our way through numbers to close  
 8        each month and each quarter and annually." *Id.* After the Class Period, Swatek  
 9        made similar statements about the prior state of the Company, noting that  
 10       SouthWest had been "a confederation of acquired companies" each with their "own  
 11       accounting practices and policies[.]" ¶ 421.<sup>25</sup> Furthermore, shortly before the Class  
 12       Period, the Company disclosed internal control weaknesses in areas that ultimately  
 13       proved to be subjects of the Restatement, demonstrating that Defendants were  
 14       aware of such weaknesses at the start of the Class Period. ¶¶ 430-31.

15       Defendants try to minimize the warning signs by arguing that they merely  
 16       show corporate mismanagement, but not scienter. SW Br. at 15. Although one or  
 17       two internal control deficiencies might only suggest negligence, *fifteen* deficiencies  
 18       are highly indicative of extreme recklessness or intentional misconduct. Also,  
 19       Defendants' argument is belied by their SOX certifications, discussed below, in  
 20       which Clary, Garnier, and Swatek represented that they were knowledgeable about  
 21       the state of internal controls. *Cf. In re ProQuest Sec. Litig.*, 527 F. Supp. 2d 728,  
 22       745 (E.D. Mich. 2007) ("[Defendants] cannot have it both ways. They cannot say  
 23       that the SOX certifications concerning knowledge of and adequacy of internal  
 24       controls were truthful, yet, at the same time claim that the controls were so deficient  
 25       that one 'rogue' employee could single-handedly be the cause of all the company's

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26       Company's accounting, so the letter is necessarily relevant to what Defendants  
 27       knew, or were reckless in not knowing, about the Company's flawed accounting.  
 28       <sup>25</sup> Nevertheless, the accounting errors alleged in the Complaint took place at the  
 corporate level, not at the subsidiaries' levels. ¶ 54.

accounting problems.”).<sup>26</sup>

#### 4. False Certifications Support a Strong Inference of Scienter

Clary’s, Garnier’s, and Swatek’s false certifications<sup>27</sup> under Sections 302 and 906 of SOX provide further support of a strong inference that they acted knowingly or recklessly. *See Stocke*, 615 F. Supp. 2d at 1190; *Middlesex*, 527 F. Supp. 2d at 1189-90 (“For these certifications to have any substance, signatories to the certifications must be held accountable for the statements.”); *Lattice*, 2006 U.S. Dist. LEXIS 262, at \*47-51.

Here, Clary, Garnier, and Swatek each filed certifications that they knew or recklessly disregarded were false when signed. These certifications asserted that the financial statements were accurate, that the signing officers had designed internal controls to ensure that material information was made known to the officers, and that the officers had evaluated the effectiveness of the internal controls. ¶¶ 104-07, 166. Moreover, they certified that all material weaknesses had been disclosed or that internal controls were effective. These statements were false. Defendants knew or were reckless in not knowing about the control deficiencies. Given the magnitude of the internal control problems, the numerous red flags, and Swatek’s statements acknowledging these problems, the Defendants who signed SOX certifications were at least “severely reckless in certifying the accuracy of the financial statements.” *Glazer Capital Mgmt., LP v. Magistri*, 549 F.3d 736, 747 (9th Cir. 2008); *see also In re OCA, Inc.*, No. 05-2165, 2006 U.S. Dist. LEXIS 90854, at \*75 (E.D. La. Dec. 14, 2006) (finding support for scienter where

<sup>26</sup> Moreover, several courts have expressly rejected Defendants’ argument that the failure to respond to red flags constitutes mere negligence, SW Br. at 15. *See, e.g., In re Health Mgmt., Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997) (“[T]he allegations of [the defendant’s] ignorance of all of these red flags present evidence of its fraudulent intent”); *In re Leslie Fay Cos. Inc.*, 871 F. Supp. 686, 699 (S.D.N.Y. 1995), *modified on other grounds*, 918 F. Supp. 749 (1996) (“[W]hile [the defendant’s] ignorance of warning signs might in one sense demonstrate it was merely negligent, allegations that, with gross recklessness, [the defendant] ignored multiple ‘red flags’ could reasonably support an inference that [the defendant] acted with intent.”); *Paincare*, 541 F. Supp. 2d at 1293.

<sup>27</sup> ¶¶ 104-07, 244, 256, 266, 281, 297, 308, 320, 334, 344, 353, 362, 375, 387, 398.

defendants certified controls were effective while at the same time failing to disclose internal control problems).

**5. Confidential Witness Allegations and the Fact that the Accounting Fraud Related to Business Activities Central to SouthWest's Business Support a Strong Inference of Scienter**

The Complaint alleges statements by a confidential witness ("CW1") that corroborate the other scienter allegations and support a strong inference that Defendants acted knowingly or recklessly. CW1 was formerly an internal control information systems consultant at SouthWest, whose duties including assessing the state of the Company's policies and procedures relating to SOX compliance. ¶ 441-42. According to CW1, SouthWest did not maintain documented policies and procedures and, critically, the Company knew that such policies and procedures were necessary for SOX compliance. ¶ 444. CW1 recognized that SouthWest would have problems justifying its accounting, would have a hard time forecasting expenses and determining financial data for various accounts, and would be unable to determine whether its acquisitions resulted in a profit or loss. ¶ 446-48. CW1 attended meetings along with Swatek and Clary to discuss the numerous problems and delays encountered in Project Cornerstone, which ostensibly aimed to improve SouthWest's internal controls. ¶¶ 31-32; 449-52.<sup>28</sup>

These allegations meet the PSLRA pleading standard because CW1 is described with sufficient particularity to establish his or her reliability and personal knowledge and CW1's statements are themselves indicative of scienter. *See Daou*, 411 F.3d at 1015-16. CW1's position, experience, and duties are described in the Complaint which is sufficient to establish CW1's reliability and personal

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<sup>28</sup> Defendants argue that the mere existence of the Cornerstone project negates an inference of scienter. SW Br. at 20. However, the Complaint alleges that, according to CW1, SouthWest's management was "neither concerned with, nor did they have an interest in, establishing SOX compliance procedures" and that the Company therefore failed to provide the time or resources necessary to make the project successful. ¶ 452.

1 knowledge. ¶¶ 441-42; *see Daou*, 411 F.3d at 1016 (describing witnesses’ job  
 2 description and responsibility sufficient to meet PSLRA pleading standard). CW1  
 3 has decades of experience in his or her field and was the person “responsible for  
 4 assessing and consulting for SOX compliance at SouthWest.” ¶ 442. CW1 also  
 5 personally attended meetings with Swatek and Clary, giving CW1 personal  
 6 knowledge about information imparted to Swatek and Clary at those meetings. ¶¶  
 7 449, 451. Defendants’ argument that CW1 is not a reliable witness because he or  
 8 she is neither an accountant nor a financial statement auditor, SW Br. at 19, ignores  
 9 CW1’s experience and role at the Company.

10 Defendants also claim that CW1 joined SouthWest too late in the Class  
 11 Period to provide relevant information. SW Br. at 19-20. Actually, CW1 joined  
 12 SouthWest in April 2008, seven months before the Class Period ended and before  
 13 several of Defendants’ false statements were made. ¶¶ 380-400, 441. Accordingly,  
 14 CW1 was well-positioned to possess the knowledge attributed to CW1.

15 A strong inference of scienter is also supported because the transactions and  
 16 business activities that form the basis of the restated financial statements relate to  
 17 SouthWest’s core operations and the acquisitions it undertook during the Class  
 18 Period. Indeed, the Ninth Circuit recently emphasized that “the core-operations  
 19 inference can be one relevant part of a complaint that raises a strong inference of  
 20 scienter.” *South Ferry*, 542 F.3d at 784; *see also Batwin*, 2008 U.S. Dist. LEXIS  
 21 52365, at\*34 (roles of officers particularly significant at small company of 80-100  
 22 employees). Here, each of the Individual Defendants was a high-ranking Company  
 23 officer who regularly dealt with the issues addressed by the Restatement, as  
 24 evidenced by their signatures on SEC filings and their statements during conference  
 25 calls. ¶¶ 29-32. The Complaint alleges that only 25 employees worked at the  
 26 corporate headquarters where the Company’s accounting for many of the  
 27 Restatement areas was performed. ¶¶ 453, 455. The Complaint also alleges that  
 28 the Restatement areas consist of the largest assets and central businesses of the



1 Company. ¶ 454. For example, the Company's largest asset, by far, was its  
 2 property, plant, and equipment, ¶¶ 49, 454, depreciation of which was materially  
 3 understated throughout the Class Period, ¶¶ 127-36, 191. As a result, these facts  
 4 strongly support the inference that each of the Defendants knew or recklessly  
 5 disregarded the false financial statements.<sup>29</sup>

## 6 **6. Motive Allegations Support a Strong Inference of Scienter**

7 The Complaint alleges numerous motives to commit fraud, each of which  
 8 contributes to a strong inference of scienter. *See Siracusano v. Matrixx Initiatives,*  
 9 *Inc.*, 585 F.3d 1167, 1182 (9th Cir. 2009) (“[M]otive can be a relevant  
 10 consideration, and personal financial gain may weigh heavily in favor of a scienter  
 11 inference[.]”) (quoting *Tellabs*, 551 U.S. at 324). In particular, a correlation  
 12 between financial results and stock options or cash bonuses for individual  
 13 defendants can support a strong inference of scienter. *No. 84 Employer-Teamster*  
 14 *Joint Council Pension Trust Fund v. Am. W. Holding Corp.* (“*America West*”), 320  
 15 F.3d 920, 944 (9th Cir. 2003). Motive allegations, however, are not necessary to  
 16 allege scienter. *Siracusano*, 585 F.3d at 1182. Here, the Complaint alleges that  
 17 Garnier's compensation was tied to SouthWest's financial performance and even  
 18 alleges the specific breakdown of the performance-based measures, including the  
 19 percentage of the incentive award attributable to earnings per share and net income  
 20 targets. ¶¶ 456-59. Garnier was eligible to receive cash bonuses of up to 100% of  
 21 his base salary if the Company met its financial goals. *Id.* Significantly, the  
 22 Company did not meet its financial goals in 2004 (before the Class Period began),  
 23

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24 <sup>29</sup> Defendants quote *South Ferry* as stating “[w]here a complaint relies on  
 25 allegations that management had an important role in the company but does not  
 26 contain additional detailed allegations about the defendants' actual exposure to  
 27 information, it will usually fall short of the PSLRA standard.” SW Br. at 20.  
 28 However, that holding applies only where “reliance on the core-operations  
 inference . . . is the only basis for scienter in the complaint.” *South Ferry*, 542 F.3d  
 at 784. *South Ferry* makes clear that “corporate management's general awareness  
 of the day-to-day workings of the company's business” may establish scienter when  
 combined with “other allegations supporting scienter.” *Id.* at 785. Here, there are  
 numerous other allegations supporting scienter, as discussed herein.

1 and consequently Garnier lost out on much of his incentive compensation that year.  
 2 ¶ 456. During the Class Period however, the Company claimed to have met its  
 3 financial targets and Garnier therefore received large cash bonuses. ¶ 457. These  
 4 allegations are sufficient to support an inference of scienter. *See America West*, 320  
 5 F.3d at 944.<sup>30</sup>

6 Furthermore, the Complaint alleges that Garnier, Moerbeek, and Clary each  
 7 sold thousands of shares of stock during the Class Period, on suspicious dates, and  
 8 that such sales were dramatically inconsistent with their pre-Class Period trading.  
 9 ¶¶ 460-63. These allegations of insider trading are sufficient to demonstrate a  
 10 motive to commit fraud. *See In re Secure Computing Corp.*, 184 F. Supp. 2d 980,  
 11 989-90 (N.D. Cal. 2001); *In re SeeBeyond Techs. Corp. Sec. Litig.*, 266 F. Supp. 2d  
 12 1150, 1168-69 (C.D. Cal. 2003) (stock sales contributed to inference of scienter).<sup>31</sup>

13 Defendants claim that some of Garnier's stock sales were made pursuant to a  
 14 10b5-1 plan, yet that fact is not alleged in the Complaint and Defendants cite to no  
 15 evidence to support their claim. Even if Defendants' unsupported assertions are  
 16 assumed to be true, such a plan would not be relevant at the pleading stage. *See*  
 17 *Stocke*, 615 F. Supp. 2d at 1193 ("[A] 10b5-1 trading plan does not provide an  
 18 absolute defense to a claim of insider trading. Rather, it requires an additional  
 19 factual finding of good faith. Not only can this Court not make such factual  
 20 findings when considering a motion to dismiss, but this Court must also draw all  
 21 inferences in favor of the non-moving party.").<sup>32</sup>

22 <sup>30</sup> The cases cited by Defendants do not support their position on this issue. In *In re*  
 23 *CornerStone Propane Partners, L.P. Sec. Litig.*, 355 F. Supp. 2d 1069 (N.D. Cal.  
 24 2005), the court held that the defendants' bonus incentives, which, as here, were  
 25 tied in part to net income targets, "squarely contribute to a strong inference of  
 scienter[.]" *Id.* at 1091-92. Defendants also quote a statement from *In re Syncor*  
*Int'l Corp. Sec. Litig.*, No. 05-55748, 2007 WL 1729968, at \*2 (9th Cir. Oct. 9,  
 2007), discussing "[s]tock-based bonuses" which are not at issue here.

26 <sup>31</sup> Defendants correctly note that the Complaint does not allege stock sales by  
 Swatek. SW Br. at 22. However, stock sales are not required to demonstrate  
 scienter. *See Siacusano*, 585 F.3d at 1182.

27 <sup>32</sup> *See also UTStarcom*, 617 F. Supp. 2d at 976 n.16. Defendants' cited authority is  
 28 not to the contrary. *Metzer Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d  
 1049, 1067 n.11 (9th Cir. 2008), merely stated, in dicta, that sales according to



Defendants also falsely claim that “Plaintiffs have allegedly a past pattern of sales that nullify an inference of scienter” for Moerbeek and Clary. SW Br. at 23. In fact, the opposite is true. The Complaint alleges that Moerbeek and Clary sold *no* stock for the two years preceding the Class Period, ¶ 462, which is drastically inconsistent with their Class Period sales. *See Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1232 (9th Cir. 2004) (that the defendant had not sold stock for five years made his class period sales “highly inconsistent with his prior trading history” and supported a strong inference of scienter).

### 7. The Complaint Alleges Scienter Against Each Defendant

Defendants raise yet another boilerplate and inapplicable argument by claiming that “Plaintiffs direct their scienter allegations at the collective group instead of each individual,” yet Defendants fail to specify even a single example of such a problem. SW Br. at 12. The truth is that the Complaint is replete with scienter allegations that identify specific Individual Defendants.<sup>33</sup> Moreover, some scienter allegations (*e.g.*, the size of the Restatement and the simple nature of the accounting violations) by their very nature are applicable generally, but that does not lessen their relevance.

Additionally, Plaintiffs are not seeking to impose liability against individuals based on statements made before they joined the Company or for which they are otherwise not responsible. Each of the Individual Defendants made false statements, by signing SEC filings and by making statements in conference calls and press releases, and it is irrelevant that they are not each responsible for every false statement that is alleged in the Complaint.

Finally, while many courts within the Ninth Circuit have held that the group-published doctrine – which permits an inference that certain documents are the collective work of high-level company officials – remains viable after the

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predetermined plans “may” rebut an inference of scienter, but did not explain when they would do so nor what showing must be made on a motion to dismiss.

<sup>33</sup> *See, e.g.*, ¶¶ 420-21, 428-29, 432, 440, 451, 456-63.

PSLRA,<sup>34</sup> it is unnecessary to resolve that question because liability here does not depend on that doctrine. The Complaint identifies the Individual Defendants that signed false SEC filings as well as those who made false statements during conference calls or in press releases.<sup>35</sup> No more is required. *See Howard v. Everex Sys.*, 228 F.3d 1057, 1061 (9th Cir. 2000); *Adaptive Broadband*, 2002 U.S. Dist. LEXIS 5887, at \*56 (“By signing the forms, which are alleged to contain a deliberately reckless and false report of [] revenue, these Defendants have themselves become liable for securities fraud.”).

#### **D. The Complaint Adequately Alleges Control Person Liability**

Defendants’ only argument regarding Plaintiffs’ Section 20(a) and 15(a) claims is that the Complaint does not adequately allege a primary violation. SW Br. at 24. Because the Complaint adequately alleges primary violations of Section 10(b) and Section 11 for the reasons discussed above, the Section 20(a) and 15(a) claims alleging control person liability are sufficiently pled. ¶¶ 33, 505-08.

#### **IV. CONCLUSION**

For all the reasons set forth herein, Plaintiffs respectfully submit that Defendants’ motion to dismiss the Complaint should be denied.<sup>36</sup> In the alternative, Plaintiffs request leave to file and serve an amended complaint to address any deficiencies identified by the Court. *See Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir. 2003) (adherence to liberal grants of leave to amend is “especially important in the context of the PSLRA”).

<sup>34</sup> *See, e.g., In re Petco Animal Supplies Inc. Sec. Litig.*, No. 05-CV-0823-H, 2006 U.S. Dist. LEXIS 97927, at \*46-49 (S.D. Cal. July 31, 2006); *In re Adaptive Broadband Sec. Litig.*, No. C 01-1092, 2002 U.S. Dist. LEXIS 5887, at \*53-54 (N.D. Cal. Apr. 2, 2002); *In re Omnivision Techs.*, No. C-04-2297, 2005 U.S. Dist. LEXIS 16009, at \*16-17 (N.D. Cal. July 29, 2005).

<sup>35</sup> *See, e.g.,* ¶¶ 253, 256, 258, 262.

<sup>36</sup> Defendants have not addressed Plaintiffs’ contemporaneous trading claim under Section 20A of the Securities Exchange Act. ¶¶ 509-15. Defendants have therefore waived any arguments regarding the sufficiency of this claim. *See Ramirez v. City of Buena Park*, 560 F.3d 1012, 1025 (9th Cir. 2009) (arguments not raised in opening brief are waived).

1 Dated: March 8, 2010

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**Appendix A: Structure of Complaint's Allegations of False and Misleading Statements under the Exchange Act**

False and Misleading Statements Relating to the 2005 First Quarter
<ul style="list-style-type: none"> <li>• Statements relating to financial results and GAAP compliance (§§ 240-42) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 243)</li> </ul> </li> <li>• Statements relating to internal controls (SOX Certifications) (§ 244) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 245)</li> </ul> </li> </ul>
False and Misleading Statements Relating to the 2005 Second Quarter
<ul style="list-style-type: none"> <li>• Statements relating to financial results and GAAP compliance (§§ 252-54) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 255)</li> </ul> </li> <li>• Statements relating to internal controls (SOX Certifications) (§ 256) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 257)</li> </ul> </li> </ul>
False and Misleading Statements Relating to the 2005 Third Quarter
<ul style="list-style-type: none"> <li>• Statements relating to financial results and GAAP compliance (§§ 262-64) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 265)</li> </ul> </li> <li>• Statements relating to internal controls (SOX Certifications) (§§ 266-67) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 268)</li> </ul> </li> </ul>
False and Misleading Statements Relating to the 2005 Fourth Quarter and Year
<ul style="list-style-type: none"> <li>• Statements relating to financial results and GAAP compliance (§§ 275-77) <ul style="list-style-type: none"> <li>• Explanation of falsity (§§ 278-80)</li> </ul> </li> <li>• Statements relating to internal controls (SOX Certifications) (§§ 281-82) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 283)</li> </ul> </li> <li>• Statements relating to Sarbanes-Oxley Act compliance (§ 284) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 285)</li> </ul> </li> <li>• Statements relating to revenues and internal controls (§ 286) <ul style="list-style-type: none"> <li>• Explanation of falsity (§ 287)</li> </ul> </li> </ul>

**False and Misleading Statements Relating to the 2006 First Quarter**

- Statements relating to financial results and GAAP compliance (§§ 293-95)
  - Explanation of falsity (§ 296)
- Statements relating to internal controls (SOX Certifications) (§§ 297-98)
  - Explanation of falsity (§ 299)

**False and Misleading Statements Relating to the 2006 Second Quarter**

- Statements relating to financial results and GAAP compliance (§§ 302-06)
  - Explanation of falsity (§ 307)
- Statements relating to internal controls (SOX Certifications) (§§ 308-09)
  - Explanation of falsity (§ 310)

**False and Misleading Statements Relating to the 2006 Third Quarter**

- Statements relating to financial results and GAAP compliance (§§ 315-18)
  - Explanation of falsity (§ 319)
- Statements relating to internal controls (SOX Certifications) (§§ 320-21)
  - Explanation of falsity (§ 322)

**False and Misleading Statements Relating to the 2006 Fourth Quarter and Year**

- Statements relating to financial results and GAAP compliance (§§ 329-31)
  - Explanation of falsity (§§ 332-33)
- Statements relating to internal controls (SOX Certifications) (§§ 334-35)
  - Explanation of falsity (§ 336)

**False and Misleading Statements Relating to the 2007 First Quarter**

- Statements relating to financial results and GAAP compliance (§§ 340-42)
  - Explanation of falsity (§ 343)
- Statements relating to internal controls (SOX Certifications) (§§ 344-45)
  - Explanation of falsity (§ 346)

**False and Misleading Statements Relating to the 2007 Second Quarter**

- Statements relating to financial results and GAAP compliance (§§ 349-51)
  - Explanation of falsity (§ 352)
- Statements relating to internal controls (SOX Certifications) (§§ 353-54)
  - Explanation of falsity (§ 355)

**False and Misleading Statements Relating to the 2007 Third Quarter**

- Statements relating to financial results and GAAP compliance (§§ 357-60)
  - Explanation of falsity (§ 361)
- Statements relating to internal controls (SOX Certifications) (§§ 362-63)
  - Explanation of falsity (§ 364)

**False and Misleading Statements Relating to the 2007 Fourth Quarter and Year**

- Statements relating to financial results and GAAP compliance (§§ 367-71)
  - Explanation of falsity (§§ 372-74)
- Statements relating to internal controls (SOX Certifications) (§§ 375-77)
  - Explanation of falsity (§ 378)

**False and Misleading Statements Relating to the 2008 First Quarter**

- Statements relating to financial results and GAAP compliance (§§ 382-85)
  - Explanation of falsity (§ 386)
- Statements relating to internal controls (SOX Certifications) (§§ 387-89)
  - Explanation of falsity (§ 390)

**False and Misleading Statements Relating to the 2008 Second Quarter**

- Statements relating to financial results and GAAP compliance (§§ 393-96)
  - Explanation of falsity (§ 397)
- Statements relating to internal controls (SOX Certifications) (§ 398-99)
  - Explanation of falsity (§ 400)

**PROOF OF SERVICE BY ELECTRONIC POSTING  
PURSUANT TO CENTRAL DISTRICT OF CALIFORNIA  
LOCAL RULES AND ECF GENERAL ORDER NO. 08-02  
AND BY MAIL ON ALL KNOWN NON-REGISTERED PARTIES**

I, the undersigned, say:

I am a citizen of the United States and am employed in the office of a member of the Bar of this Court. I am over the age of 18 and not a party to the within action. My business address is 1801 Avenue of the Stars, Suite 311, Los Angeles, California 90067.

On March 8, 2010, I caused to be filed the following document by posting such documents electronically to the ECF website of the United States District Court for the Central District of California:

- 1. OPPOSITION OF LEAD PLAINTIFFS TO DEFENDANT SOUTHWEST WATER COMPANY'S, ANTON C. GARNIER'S, MARK A. SWATEK'S, CHERYL L. CLARY'S, AND PETER J. MOERBEEK'S MOTION TO DISMISS CONSOLIDATED AMENDED CLASS ACTION COMPLAINT**
- 2. DECLARATION OF MICHAEL GOLDBERG [EXHIBITS A-G]**
- 3. OPPOSITION OF LEAD PLAINTIFFS TO DEFENDANT SOUTHWEST WATER COMPANY'S, ANTON C. GARNIER'S, MARK A. SWATEK'S, CHERYL L. CLARY'S, AND PETER J. MOERBEEK'S MOTION FOR PARTIAL SUMMARY JUDGMENT**
- 4. DECLARATION OF MICHAEL GOLDBERG [EXHIBITS A-B]**
- 5. PARTIAL OPPOSITION OF LEAD PLAINTIFFS TO DEFENDANT KPMG LLP'S REQUEST FOR JUDICIAL NOTICE**
- 6. STATEMENT OF GENUINE ISSUES OF MATERIAL FACT IN OPPOSITION TO DEFENDANT SOUTHWEST WATER COMPANY'S, ANTON C. GARNIER'S, MARK A. SWATEK'S, CHERYL L. CLARY'S, AND PETER J. MOERBEEK'S MOTION FOR PARTIAL SUMMARY JUDGMENT**
- 7. AFFIDAVIT OF DANIEL S. SOMMERS PURSUANT TO RULE 56(f)**
- 8. LEAD PLAINTIFFS' MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO DEFENDANT KPMG LLP'S MOTION TO DISMISS THE CONSOLIDATED AMENDED CLASS ACTION COMPLAINT**



1     **9.           DECLARATION OF MICHAEL GOLDBERG IN SUPPORT OF**  
2               **LEAD PLAINTIFFS' OPPOSITION TO DEFENDANT KPMG**  
3               **LLP'S MOTION TO DISMISS THE CONSOLIDATED**  
4               **AMENDED CLASS ACTION COMPLAINT [EXHIBITS 1-4]**

5     **10.          LEAD PLAINTIFFS' REQUEST FOR JUDICIAL NOTICE IN**  
6               **SUPPORT OF OPPOSITIONS TO DEFENDANT KPMG AND**  
7               **THE SOUTHWEST WATER COMPANY DEFENDANTS'**  
              **MOTIONS TO DISMISS THE CONSOLIDATED AMENDED**  
              **CLASS ACTION COMPLAINT**

8     and, simultaneously served upon the following ECF-registered parties:

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24    There are no non-ECF-registered parties.

25               I certify under penalty of perjury under the laws of the United States of  
26    America that the foregoing is true and correct. Executed on March 8, 2010, at  
27    Los Angeles, California.

28                               **S/Michael Goldberg**  
                              Michael Goldberg